

**CALPINE  
NATURAL RESOURCES DEFENSE COUNCIL  
PACIFICORP**

**A JOINT PROPOSAL TO STATE UTILITY REGULATORS:  
DEFINING ELECTRICITY-RESOURCE PORTFOLIO MANAGEMENT RESPONSIBILITIES  
JULY 2003**

*Calpine, the Natural Resources Defense Council, and PacifiCorp agree on, and release for distribution, the following statement and recommendations.*

**PROBLEM STATEMENT**

Among the most crucial responsibilities of load serving electric utilities is electricity-resource “portfolio management” for their service territories, at least for retail customers served on a traditional regulated basis or otherwise unable or unwilling to choose another provider, and for load assigned on a “default” basis to those utilities. This involves assembling a mix of demand- and supply-side resources designed to ensure reliable, affordable and environmentally sustainable electricity service with an acceptable level of price and delivery risk to both customers and the utility, consistent with state and federal policy. Load serving electric utilities need not own all or even some of the resources involved, and an active portfolio management role for load serving electric utilities is wholly consistent with efforts to create and promote competitive wholesale generation markets. Indeed, participants in such markets increasingly are calling for more long-term investment to overcome a capital availability crisis that threatens a host of urgently needed infrastructure upgrades, affecting all elements of the grid and, by extension, the wholesale marketplace. For their part, load serving electric utilities and the financial community understandably are concerned about risks associated with cost recovery, and customers want stable and affordable electricity bills through traditional cost of service tariffs or through their own actions if retail direct access is available.

We recognize that portfolio management practices and regulations differ widely across the country, and that State regulators have reached varying conclusions about how to define and allocate this responsibility. An increasing number of States require load serving entities to undertake competitive bidding processes to procure incremental or replacement supplies of power. Such State processes typically result in market-priced purchased power agreements (PPAs) of varying duration and complexity, whose costs are then embodied, subject to commission approval, in the utilities’ rates. In States where utilities are members of regionally administered ISOs/RTOs, operational and market rules usually require load serving entities to demonstrate availability of short- and long-term supplies of sufficient certainty to satisfy service scheduling requirements. Some ISOs/RTOs operate capacity markets to support this objective. We believe, however, that the recommendations that follow below are broadly applicable and accommodate the States’ diverse and evolving regulatory approaches.

More than a decade ago, the National Association of Regulatory Utility Commissioners (NARUC) urged State regulators to “ensure that the successful implementation of a utility’s

least-cost [investment and procurement] plan is its most profitable course of action.”<sup>1</sup> The resolution framed the term “least-cost” over an extended time horizon. Congress endorsed NARUC’s objective in the National Energy Policy Act of 1992, for both electric and gas utilities, although the final decision remains with State regulators.<sup>2</sup> Traditional rate regulation distorts portfolio management in two crucial ways: First, it links financial health to throughput over the wires, penalizing load serving electric utilities’ investments in energy-efficiency and “supply-side like” resources located on the customer’s side of the meter (by reducing revenues and therefore cost recovery); and it omits any performance-based incentive to minimize the long-term cost of reliable and efficient service. This often results in the management of load serving electric utilities viewing many resource-related costs as merely a passthrough to customers rather than an opportunity to enhance economic value through demonstrated achievements. Additionally, in many States, load serving electric utilities have no way of securing cost recovery over the extended duration of long-term resource decisions, resulting in potentially higher project financing expenses and consequently higher customers’ bills, due to the higher cost of capital.

### **PLANNING AND PROCUREMENT RECOMMENDATIONS FOR ELECTRIC-RESOURCE PORTFOLIO MANAGERS AND THEIR REGULATORS**

Through these recommendations, we hope to help regulators and resource portfolio managers to consider and evaluate the best possible long-term resource options for their systems and for the customers they serve, and to weigh the cost/risk balance appropriately from both economic - environmental and customer - utility perspectives:

1. Create a public process for upfront regulatory review and approval or disapproval of load serving electric utilities’ proposed long-term electric-resource portfolios, including reasonable and durable assurances of cost recovery for approved long-term resource acquisitions and adequate flexibility to respond to evolving conditions over time. Without such assurances, financing for the resources (whether built by the load serving utility or by another entity) will be difficult if not impossible to secure, and it will be much more costly than necessary for all parties involved, including customers. Some States may need legislation in order to establish such a system; a good model can be found in the provisions of Montana’s SB 247 that authorize the Public Service Commission (PSC) to grant advanced approval of long-term resource decisions at the outset, following review of proposed procurement agreements, rather than in a later rate making process. Furthermore, the resulting cost recovery schedule should closely track the actual payment obligations associated with the approved long-term investments. Such upfront authorizations may require coordination across multiple affected States, and in such cases an equitable interstate allocation of all approved costs is crucial.
2. Use a public process to identify resource procurement requirements, and the specific resource criteria that will meet those requirements. The criteria should be weighted to reflect the relative importance of resource characteristics and should include cost/benefit analyses that customers and stakeholders can weigh. Long-term energy efficiency improvements and

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<sup>1</sup> NARUC, Profits and Progress Through Least-Cost Planning, at 57 (November 1989) (from Resolution in Support of Incentives for Electric Utility Least-Cost Planning, adopted July 27, 1989).

<sup>2</sup> See 16 USC section 2621(d)(8).

short-term demand reduction options are among the “resources” that should be evaluated for this purpose.

3. Utilities should be compensated for the costs and risks that they take on by acquiring and managing electric-resource portfolios for their customers, and, through the application of an incentive mechanism based on objective benchmarks, for making good procurement decisions.
4. Load serving electric utilities’ determination of resource procurement requirements should be based upon reliability and economic considerations, consistent with state and federal policy:
  - a) Resources are needed for reliability reasons when the utility forecasts an inadequate reserve margin or the need to address a system constraint by adding a resource with specific characteristics.
  - b) Resources are needed for economic reasons when it is expected to be cost efficient to displace, upgrade, or otherwise enhance inefficient or unreliable generation with a resource solution, resulting in a lower overall cost or a better balance of cost and risk in the long run. Financial and operational risks associated with environmental regulation of existing and new resources, such as potential costs associated with carbon dioxide emissions or output reductions due to emissions constraints, should be explicitly included in the analysis.
5. Once a generation resource procurement need is identified, a competitive resource procurement process should be undertaken that is transparent to regulators, unbiased, and free of conflict of interest. A competitive procurement process should be designed to permit an objective evaluation of expected direct costs as well as the financial and operational risks associated with fuel price volatility, resource reliability, credit worthiness associated with potential suppliers, and future environmental regulations. In the energy efficiency context, load serving electric utilities should have flexibility in designing incentive, delivery, risk management and quality assurance mechanisms. The process should also create reasonable opportunities for the involvement of qualified third party efficiency service providers, as well as adequate assurances with respect to their performance.
6. If a utility or one of its affiliates is participating in the procurement process as an offeror of efficiency services or power supply, restrictions may be needed to ensure an unbiased outcome if no affiliate interest legislation or regulatory guidelines are already in place. Customers should not be expected to pay for preferential treatment of affiliates by utilities, nor should they be denied access to superior resources simply because they are owned by an affiliate of their load serving utility. This may include the use of an independent and credible contractor with demonstrated experience in procuring various resource types. The purpose of this independent entity is to monitor the process and serve other functions designed to ensure an unbiased acquisition process. This entity should be chosen based on a set of pre-defined criteria established by the regulatory commission.
7. Inappropriate asymmetries of risk and reward, linked to resource ownership, could adversely affect the resource acquisition and development process. Regulators should seek to ensure that utility-owned resources and independently owned resources stand on a comparable footing, from the perspective of the utility itself, its customers and its obligation to serve its customers in terms of potential risk and reward. The mechanisms employed for this purpose

may have to vary depending on State statutory provisions, including those addressing cost-of-service issues, but the objective is both important and feasible across a wide range of regulatory models.

8. Consistent with FERC policies and regulations, the utility should clearly identify its policy with respect to the process for a generator to interconnect to the transmission network, and with respect to transmission delivery arrangements. More specifically:
  - a) Generation Interconnection – The generation owner (utility included) will need to work directly with the transmission function of the utility (or alternatively the transmission entity who provides service to the utility) with respect to interconnection requirements and any related engineering studies in order to allow for a safe interconnection. A utility should assume that the owner of the generation would pay for all such interconnection costs consistent with FERC policy (studies, legal fees, system stability mitigation equipment, and interconnection facilities), unless an alternative arrangement has specifically been put into place.
  - b) Transmission Delivery – The utility should clearly define which entity (the utility or the seller) will bear which type of transmission delivery expenses. For example, if the utility resides in an electrical control area from which deliveries can be made from adjacent control areas, the utility should clarify who will bear the expense(s) associated with the delivery of power to the control area that the utility resides in (such that the resource may be considered as a resource available to serve the utility’s network of loads). Likewise, the utility should also clarify, consistent with FERC policy, how congestion expenses and/or capital construction expenses (associated with necessary system upgrades in order to allow the delivery of power from the point of delivery to the utility’s loads) will be allocated. For resources intended to serve the utility’s network of loads, the utility should clearly identify delivery points in or to the utility’s network transmission provider, such that the resource may be considered as a network resource. However, a bidder should not be required to purchase transmission from the utility’s network transmission provider to reach these points unless the utility, if it owned a resource at the same location as the bidder, would have to purchase the same incremental transmission in order to reach the delivery point(s).
9. The resource procurement process itself should provide a basic framework for evaluating proposals on a comparable basis, but should be flexible enough to allow for bidders to customize their proposal in a way that enhances value to the utility’s customers. The process should allow for ongoing negotiation between the utility and the bidder to achieve the best possible outcome.
10. In addition, to eliminate a powerful disincentive for utilities to promote energy efficiency policies and programs, regulators should use modest, regular true-ups in electricity rates to ensure that utilities’ opportunities to recover their fixed-cost revenue requirements is independent of metered electricity use by the utility’s retail customers. The details of such mechanisms require careful attention, and acceptability to any party depends on those details, but we agree that it is possible to design systems that are simple to execute and work well for load serving utilities as well as other interested parties.

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## **APPENDIX: ILLUSTRATIVE EXCERPTS FROM RECENT STATE STATUTES AND REGULATIONS ON ELECTRIC RESOURCE PORTFOLIO MANAGEMENT**

### **I. MONTANA'S AUTHORIZATION OF ADVANCED APPROVAL OF POWER PURCHASE AGREEMENTS IN SB 247**

**Recital** - "An act establishing a default supply procurement process; . . . requiring the Commission to establish an electricity cost recovery mechanism for prudently incurred electricity supply costs;"

**Section 1.(2).(c)** - "Identify and cost effectively manage and mitigate risk related to its obligation to provide default electricity supply service."

**Section 1.(2).(d)** - "Use open, fair, and competitive procurement processes whenever possible."

**Section 3.(1)** - "A default supplier may apply to the commission for advanced approval of a power supply purchase agreement that is (a) not executed; or (b) executed with a provision that allows termination of the agreement if the commission does not find the agreement reasonable."

**Section 3.(2).(a)** - "The commission shall issue an order on the default supplier's application for advanced approval of a power supply purchase agreement in a timely manner as provided in this subsection (2)."

**Section 3.(3).(c)** - "A commission order granting advanced approval of a power supply purchase agreement must include the following findings:

- (i) advanced approval of all or part of the agreement is in the public interest,
- (ii) the agreement resulted from a reasonable effort by the default supplier to comply with the objectives in [Section 1] and the rules adopted pursuant to [Section 1]; and
- (iii) the price, quantity, duration, and other contract terms directly related to the price, quantity, and duration of the power supply purchase agreement are reasonable."

**Section 3.(4)** - "Notwithstanding any provision of this chapter to the contrary, if the commission has issued an order containing the findings required under subsection (3)(c), the commission may not subsequently disallow the recovery of costs incurred under the agreement based on contrary findings."

**Section 3.(6)** - "Nothing limits the commission's ability to subsequently, in any future cost recovery proceeding, inquire into the manner in which the default supplier has managed a power supply purchase agreement as part of its overall portfolio. The commission may subsequently disallow default supply costs that result from the failure of a default supplier to reasonably administer power supply purchase agreements in the context of its overall default supply portfolio management and service obligations."

**Section 3.(7)** - "The commission may engage independent consultants or advisory services to evaluate a utility's default supply resource procurement plans and proposed power supply purchase agreements. The consultants must have demonstrated knowledge and experience with electricity supply procurement and resource portfolio management, modeling, and risk management practices. The commission shall charge a fee to the default supplier to pay for the costs of consultants or advisory services. These costs are recoverable in default supply rates."

**Amendment to 69-8-210, Subsection (2)** – “The commission shall establish an electricity cost recovery mechanism that allows a default supplier to fully recover prudently incurred electricity supply costs, subject to the provisions of [Sections 1 and 2]. The cost recovery mechanism must provide for prospective rate adjustments for cost differences resulting from cost changes, load changes, and the time value of money on the differences.”

## **II. EXCERPT FROM MONTANA PUBLIC SERVICE COMMISSION’S RESOURCE PROCUREMENT REGULATIONS**

### **[RULE IV, CODIFIED AT ARM 38.5.8204 ]**

(1) In order to satisfy its default supply responsibilities, a default supply utility (DSU) should pursue the following objectives in assembling and managing an electricity supply portfolio:

- a) provide default supply customers adequate and reliable default supply services, stably and reasonably priced, at the lowest long-term total cost; . . .
- c) assemble and maintain a balanced, environmentally responsible portfolio of power supply and demand-side management resources coordinated with economically efficient cost allocation and rate design that most efficiently supplies . . . electricity supply service to default customers over the planning horizon; and
- d) maintain an optimal mix of demand-side management and power supply sources with respect to underlying fuels, generation technologies and associated environmental impacts, and a diverse mix of long, medium and short duration power supply contracts with staggered start and expiration dates[.]

*[The remainder of the rule establishes detailed guidelines and procedures for achieving these objectives]*

## **III. EXCERPTS FROM OREGON’S ORDER #91-1383 REGARDING COMPETITIVE BIDDING GUIDELINES:**

- “Bidding should be viewed as one of the many pathways the utility may follow to achieve the least cost planning goal of acquiring the resource mix with the best combination of costs and variance of costs (page 4)”;
- “In general, the Commission supports a flexible approach which can evolve over time (page 4)”;
- “At the same time, if bidding is to be successful, it is necessary that potential non-utility developers know the rules of participation, understand the ranking and selection process, and consider the probability of success and monetary rewards sufficient to justify the costs of participation (page 4)”;
- “For Oregon to pursue competitive bidding, the process should satisfy the following goals (page 5):
  - Provide the opportunity to minimize long-term energy costs, subject to economic, legal and institutional constraints,
  - Complement Oregon’s least-cost planning process (as described in OPUC Order 89-507),

- Not unduly constrain utility management prerogative to acquire new resources through means other than competitive bidding,
- Be flexible, allowing the contracting parties to negotiate mutually beneficial exchange agreements,
- Be understandable and fair.”
- “The Commission will review the RFP for compliance with this order and consistency with the utility’s least-cost plan. The Commission will not concern itself with substantive terms or technical details of an RFP for other purposes (page 8)”;
- “Pricing terms may, however, be adjusted in post-bid negotiations (page 17)”;
- “Utilities using the bidding process will have the benefit of shifting to a third party the financial risks associated with building generation resources (page 28).”

#### **IV. CONSENSUS-BASED PRINCIPLES REGARDING PERFORMANCE-BASED INCENTIVES FOR CALIFORNIA UTILITIES’ RESOURCE PROCUREMENT**

[Joint Recommendations by San Diego Gas & Electric, Pacific Gas & Electric, Southern California Edison, Office of Ratepayer Advocates, Energy Division, The Utility Reform Network/ Utility Consumers Action Network, Natural Resources Defense Council, The California Farm Bureau Federation, and the California Independent System Operator]

The adopted mechanism should:

- Align customer and shareholder interests in the procurement of the electric service portfolio in a manner that appropriately balances resource adequacy, low cost stable prices and environmental sustainability;
- Streamline regulatory oversight, including the elimination of hindsight reasonableness reviews of covered procurement activity, consistent with AB 57;
- Give balanced consideration to the procurement of both long- and short-term supply- and demand-side resources while effectively integrating both components;
- Include both purchases and surplus electric sales;
- Avoid encouraging an over reliance on the real-time electricity market;
- Be acceptable to the utility to which it is applied;
- Establish one or more benchmarks or standards against which utility procurement performance is measured; include a fair and balanced sharing of the potential risks and rewards between customers and shareholders; adopt a dead-band within which no risk or reward would occur; provide adequate financial incentive to encourage the utility to respond to the challenge of beating the benchmark; and be consistent with a minimum level of resource adequacy as set by the appropriate regulatory bodies;
- Include structural elements that bound risks. Such mechanisms could include caps or bounds on gains or losses, off-ramps, force majeure conditions or similar provisions;
- Specify the mechanism and the condition for its termination, modification or enhancement;
- Provide for periodic quantifiable and verifiable review of the results; and
- Minimize the potential for unintended behavior and consequences.